Commodities: Latest Boom, Plentiful Risk

By Diana B. Herriques

The booming commodities market has become increasingly attractive to investors, with hard assets like oil and gold perhaps offering a safe hedge against inflation, as well as the double-digit gains that have fast been disappearing from the markets for stocks, bonds and real estate.

Undeterred by the kind of volatile downdrafts that sent oil plunging 4.5 percent Wednesday, to settle at $104.48 a barrel, large funds and rich individual investors have sent a torrent of cash into this arcane market over the last year, toppling records for new money flowing in.

Small investors are plunging in, too, using dozens of new retail commodity funds to participate in markets that by one measure have jumped almost 20 percent in the last six months and doubled in six years.

But this market, despite its glitter, offers risks of its own, including some dangerous weaknesses that are impairing the ability of regulators to police fraud and protect investors. Commodities are also vulnerable to the same worries affecting the rest of Wall Street, where on Wednesday the Dow Jones industrial average plunged almost 300 points, erasing more than two-thirds of Tuesday's steep gains.

Moreover, the biggest speculators and lenders in the commodities markets are some of the same giant hedge funds, commercial banks and brokerage houses that are caught in the stormy weather of the equity, housing and credit markets.

As in those markets, an evaporation of credit could force some large investors — especially hedge funds speculating with lots of borrowed money — to sell off their holdings, creating price swings that could affect a host of marketplace prices and wipe out small investors in just a few moments of trading.

"Right now is a very scary time" for commodity market regulators, said Michael Riess, a director of the International Precious Metals Institute, a consultant to commodities investors for more than 30 years. "It's not a question of overregulating or underregulating. It's a question of just being swamped by volume, volatility and a dramatic shift toward speculative interests."

Developments on Wall Street in the last few days underscored the new risks. Both Bear Stearns and its prospective new owner, JPMorgan Chase, are important clearing brokers that process and guarantee their clients' trades in the commodities markets.

Officials at the exchanges where those trades occur had to monitor Bear Stearns's financial situation carefully throughout last week to ensure that its cash shortage did not affect its commodity positions or those of its clients.

Walter L. Lukken, who heads the federal agency that regulates most commodity markets, said his staff had been able, so far, to cope with both the markets' growth and the recent tremors from Wall Street.

"Even with the enormous volume coming through," said Mr. Lukken, acting chairman of the Commodity Futures Trading Commission, "we think we have gotten a very good handle on the market. You can't catch them all, of course, and you worry that something will get past the goalie. But we have been able to scale up the regulatory monitoring system to deal with increasing volume."

Regulators and exchange officials take comfort from the rising commodity prices, which reduce the risk that lenders will grow nervous about their collateral and withhold new credit. Despite a broad commodities sell-off yesterday, a Commodity Research Bureau index remains almost 40 percent higher than a year earlier.

But it has been a roller coaster: commodity prices can record daily percentage changes that dwarf typical movements in stocks. Yesterday, when crude oil gave back some of its 85 percent annual gain and gold dropped almost 6 percent after an annual gain of 44.5 percent, the Standard & Poor's 500-stock index fell 2.4 percent, leaving it down 7.4 percent over the last year. On its worst single day over the last year, it fell 3.2 percent.

So stock market investors seeking these formidable gains will find themselves on unfamiliar terrain. The heart of commodities markets is the so-called cash market, a "professionals only" setting where producers sell boatloads of iron ore, tanker ships full of oil and silos full of wheat for immediate use.

Wrapped around that core are the commodities futures markets. Here, hedgers and speculators trade various versions of a derivative called a futures contract, which calls for the delivery of a specific quantity of a commodity at a fixed price on a particular date.

Futures contracts trade both on regulated exchanges and in the immensely larger but less regulated over-the-counter market, where banks and brokers privately negotiate futures contracts with hedgers and speculators around the world.

The prices at which all these contracts trade indicate the potential strength of demand and supply for commodities still in the ground or in the fields. That makes them important to everyone who produces, buys and uses those goods — wheat farmers, baking companies, grocery shoppers, oil companies, electric utilities and homeowners.

Prices here can also influence the values of the increasingly popular exchange-traded funds, or E.T.F.'s, that focus on commodity investments. Born barely four years ago, these funds had net assets of $32.8 billion in January, compared with less than $4.8 billion in 2005.

But as the futures markets have grown, the ability of federal regulators to police them for fraud and manipulation has been shrinking, as a result of legislative loopholes and adverse court decisions. And despite widespread agreement that these regulatory gaps are bad for investors and consumers, they have not yet been repaired.

The oldest of these is the so-called Enron loophole, an 11th-hour addition to the Commodity Futures Modernization Act of 2000 that gave an exemption to private energy-trading markets, like the one operated by Enron before its scandalous collapse in 2001. Regulators later accused Enron traders of using this exempt market to victimize a vast number of utility customers by manipulating electricity prices in California.

Related to that loophole is a broader one for a category called exempt commercial markets, envisioned in the 2000 law as innovative professional markets for nonfarm commodities that did not need as much scrutiny as public exchanges.

What lawmakers did not anticipate was that one of the exempt markets, the IntercontinentalExchange, known as the ICE and based in Atlanta, would become a hub for trading in a product that mirrors the natural gas futures contract trading on the regulated New York Mercantile Exchange.

In 2006, traders at a hedge fund used the ICE's look-alike contract as part of what regulators later asserted was a scheme to manipulate natural gas prices, again at great cost to users. The fund denied the accusation, and civil litigation is pending.

That case persuaded the commission that it needed more power to police these exempt markets, at least when they help set commodity prices. But so far, it has not received it, despite repeated requests to Congress.

Another attempt to close these loopholes is attached to the pending farm bill, which is scheduled to emerge from a Congressional conference committee next month. But this latest effort, too, faces market and industry opposition.

The courts have also curbed the commission's reach. In three cases since 2000, judges have interpreted federal law to severely limit the commission's ability to fight fraud involving both over-the-counter markets and specious foreign currency contracts used to victimize individual investors.

The commission has filed appeals, but a far quicker remedy would be for Congress simply to revise the laws, as the commission requests.
Mr. Lukken said he was confident that passage of the commission's proposed language as part of the farm bill would address those shortcomings, as well as the exempt-market problem.

Finally, the commodities market has not yet dealt with what some economists say are inherent conflicts that have arisen as the futures exchanges, which have substantial self-regulatory duties, have been converted into for-profit companies with responsibilities to shareholders that could conflict with their regulatory duties. (For example, shareholders may benefit when an exchange's regulatory office ignores infractions by a trader who generates substantial income for the exchange.)

By contrast, when the New York Stock Exchange and Nasdaq became profit-making entities, they spun off their self-regulatory units into an independent agency, now called the Financial Industry Regulatory Authority.

The C.F.T.C. never encouraged that approach, trying instead — so far unsuccessfully — to adopt principles that would encourage the for-profit exchanges to add independent directors to oversee their self-regulatory operations.

Independent directors do not owe any less loyalty to shareholders than management directors would, said Benn Steil, director of international economics at the Council on Foreign Relations. "The statutory regulators have got to acknowledge these conflicts and act accordingly," he said.

His view is opposed by Craig Donohue, chief executive of the CME Group, the for-profit company that operates the Chicago Mercantile Exchange and the Chicago Board of Trade and may soon merge with the New York Mercantile Exchange.

“We succeed because we are regulated markets, among other things. That’s part of our identity and brand,” Mr. Donohue said. Effective self-regulation, he added, is “very consistent with the shareholder interest.”

Mr. Lukken nevertheless plans to push ahead with his call for more public directors. “The important point is trying to minimize and manage conflicts,” he said. “Public directors are uniquely qualified to balance the interests of the public as well as the requirements of the act.” Although the effort has been delayed, he added: “This is not an indefinite stay. It’s a priority of mine that we hope to complete in the coming months.”
But some with experience in the commodities market remain nervous about the new money pouring in so quickly.

Commodity trading firms that have survived for any length of time have excellent risk-management skills, said Jeffrey M. Christian, managing director of the CPM Group, a research firm spun off from Goldman Sachs in 1986. Mr. Christian said he was less certain how the newcomers would deal with risk.

“You have the stupid money coming into the market now,” he said last week. “And I think the smart money is beginning to get a little frightened about what the stupid money will do.”

By Diana B. Herriques